For FHA, a Huge Task and Uncertain Role

As Proposals Put Onus on Agency to Aid Homeowners, Its Officials Cite Great Risk

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The Federal Housing Administration has a big new role to play in untangling the mortgage mess, but even the agency itself does not know whether it can or should handle some of the tasks it is being asked to perform.

After steadily losing relevance and customers to aggressive private lenders during the housing boom, the FHA is being asked to "pick up the pieces," as one official put it, for strapped borrowers.

Just about every major housing proposal has the FHA helping refinance troubled borrowers into its government-backed mortgages. By doing so, the agency would take on even riskier loans than it is used to handling.

Whether it should do that may be more of a philosophical issue than an operational one. But if the agency fails, many fear that taxpayers will take a hit. The proposals come at a time of financial stress for the FHA. For the first time in its 74-year history, it may need taxpayer money to fund its flagship home-buying program next year.

The House expects to vote today on a package that would dramatically expand the FHA's role in responding to the housing crisis. The package also includes a long-awaited measure to modernize the agency and increase the size of the loans it insures.

The Bush administration supports FHA modernization but yesterday threatened to veto the FHA expansion championed by Rep. Barney Frank (D-Mass.). The federal government "should not be the lender of last resort, with the private sector dumping bad loans on FHA," said Roy A. Bernardi, deputy secretary of the Department of Housing and Urban Development, which includes the FHA.

Some lawmakers have raised similar concerns. Sen. Patty Murray (D-Wash.), who heads a Senate panel that oversees housing appropriations, said Congress needs to "get real" about the FHA's ability to manage more troubled loans.

The FHA does not lend money directly. It provides mortgage insurance to borrowers through private lenders. Traditionally, those lenders have considered only borrowers who have at least 3 percent equity in their homes and who can document their income.

Since its creation in 1934, the program has been self-sustaining, meaning no public money has been used to cover its losses. Instead, FHA borrowers pay premiums to cover defaults and foreclosures.

Those premiums are kept in a reserve fund, which totals more than $21 billion, according to the FHA's independent auditor. By that measure, the agency is financially sound. Some who track the FHA say its finances should improve as it wins back its bread-and-butter customers -- first-time home buyers, minorities and low- to moderate-income families.

When house prices soared, those borrowers turned to more affordable subprime adjustable-rate loans, many of which did not require down payments or income verification. When values dropped, defaults increased and subprime loans just about vanished. A credit crunch ensued, and demand for the FHA's vanilla fixed-rate mortgages grew.

The number of FHA loans issued for home purchases and refinancing shot up 126 percent in the first quarter of this year compared with a year earlier, federal data show.

"With the collapse of the subprime lending business, [the FHA] has started to rise not only from its own ashes but from the ashes of the larger mortgage market," said Guy Cecala, publisher of Inside Mortgage Finance. "Many are pinning their hopes on the survival of a booming FHA business."

Brian Chappelle, who oversaw the FHA's loan production activities in the mid-1980s, said the bulk of the agency's new business is coming from solid borrowers who want to refinance their conventional loans into cheaper FHA mortgages.

"The FHA is getting a much better-quality borrower than it is used to," said Chappelle, who now runs Potomac Partners, a mortgage banking consulting firm. "Those borrowers' premiums will keep the fund healthy and growing."

FHA officials said any gains the agency makes by attracting more creditworthy borrowers would be offset by an influx of poorer-quality ones if Congress adds to the FHA's loan volume.

Frank and Sen. Christopher J. Dodd (D-Conn.) have each offered legislation in their respective chambers aimed at rescuing borrowers who owe more than their houses are worth.

The Frank legislation, which the House expects to vote on today, would allow certain borrowers to refinance into FHA loans if their lenders agree to forgive a portion of their debt and if their loans were issued before Jan. 1, 2008.

The program could nearly double the FHA's loan portfolio by granting it authority to insure an additional $300 billion of mortgages.

During a speech Monday night, Federal Reserve Chairman Ben S. Bernanke appeared to endorse an expanded FHA role that would encourage lenders to write off a portion of debt for borrowers who owe more than their homes are worth.

The Congressional Budget Office estimates that the Frank bill would cost taxpayers $2.7 billion from 2008 to 2013 and help 500,000 borrowers -- less than the 1 million initially projected by supporters.

Frank, who heads the House Financial Services Committee, said he's confident that the FHA could handle the cost and workload because it would receive additional money and personnel to administer the four-year program.

Frank said using the FHA is logical. "The alternative would have been to create a new agency from scratch, which would have guaranteed that we would not get prompt action," he said in an interview. "By the time it got fully operational, we wouldn't need it anymore."

But FHA officials said the proposal was "extreme" and "overly prescriptive." The administration prefers the more targeted program it launched in August, called FHA Secure. That refinances only subprime, adjustable-rate loans and only for those who missed no more than three payments. The Frank bill applies to all loans without regard for the borrower's payment history. FHA Secure has refinanced loans for about 180,000 borrowers, only 3,000 of whom were delinquent. Initially, the administration said it would reach 60,000 late borrowers.

Part of the legislation under consideration on the House floor today is a provision that would reform the FHA. The Senate has passed a similar measure. The FHA hopes that when the two are reconciled, the final legislation would get rid of one-size-fits-all premiums and charge borrowers based on risk.

Agency officials also hope the legislation would ban popular seller-funded down-payment-assistance programs in which home sellers give money to charities, which help buyers make down payments.

This arrangement has led to an unacceptable level of defaults and foreclosures that the FHA can no longer sustain, said Brian Montgomery, the FHA's commissioner.

Without these changes, the FHA will be facing financial pressure next year, Montgomery said.

By law, the FHA must break even each year, meaning it must collect more in premiums than it pays to cover foreclosure-related losses. If at the start of a year the FHA estimates it cannot do that, then the Senate and House appropriations panels make up the shortfall using taxpayer money.

Because of the poor performance of seller-funded down-payment loans, the FHA may ask for $1.4 billion in appropriations for the fiscal year beginning Oct. 1 -- the first appropriation in its history.

At his FHA office, Montgomery said that the mortgage crisis could have been averted had Congress heeded his pleas to overhaul the FHA in 2006 so his agency could better compete with subprime rivals.

"I'm back here now trying to pick up the pieces, and they're telling me you're just not doing enough," he said. "It's a little disingenuous."